Determinants of Exchange Rate Movements

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ABSTRACT

The economy is comprised of many activities that fulfill human needs. The fluctuations of economy depend on variety of economic tools in any country. The exchange rate is one of the most important macro economic tool, since it links the domestic economy and the rest of the economies together. In the recent past, countries have shown a tendency to choose either hard peg or freely float system in determining their exchange rate. Since January 2001 Sri Lanka was abandoned the existing floated system which were governed by the Central Bank to a free float system by allowing greater freedom in determining the exchange rate through market forces. Therefore identification of the macro economic factors is significant in determination of exchange rate. In this study we have taken the Nominal Effective Exchange Rate (NEER) as the dependent variable and interest rate, inflation rate and GDP growth rate as the macro economic variables. Three months Treasury bills rate is represent the interest rate and Weighted Price Index (WPI) is for the calculation of the inflation. This study will be basically using secondary data sources such as Central Bank annual reports, and Central Bank Website. The time period for this study considered from year 2005 to 200based on quarterly balances. For analysis of data regression and correlation coefficient were used. The result shows that the correlations between the dependent variables and the independent variables have strong relationship and the regression results shows that the selected macroeconomic variables are significant in determining the exchange rate. Overall results conclude that the exchange rate is insightful to the macro economic variables.

Key words- Exchange rate, Interest rate, Inflation rate, Gross Domestic Product